

TEACHERS' RETIREMENT BOARD  
BUDGETS AND AUDITS COMMITTEE

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SUBJECT: Internal Audits Follow-up Status Report

ITEM NUMBER: 10

ATTACHMENTS: 2

ACTION: \_\_\_\_\_

DATE OF MEETING: October 11, 2001

INFORMATION: X

PRESENTER: Way Lee

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In accordance with Internal Auditing Standards (Standards), we have taken steps to follow-up on prior internal audits performed by the Office of Audits. Follow-up procedures are required to ascertain that appropriate action was taken regarding audit findings (or observations) identified within final audit reports. At attachment 1 we have provided our quarterly report on the current status of the resolution of our prior audit findings/observations. At attachment 2 we have provided a current status report on all internal audits completed since January 1997. We intend to provide the Budgets & Audits Committee with a similar quarterly status report on an ongoing basis.

Internal Auditing Standards recognize that management is responsible for deciding the appropriate action to be taken in response to reported audit findings and that management may decide to assume the risk of not correcting the reported condition because of cost or other considerations. The Internal Auditing Director is responsible for assessing management's action and determining the nature, timing, and extent of follow-up procedures necessary. In determining the appropriate follow-up procedures for each finding/observation, the Standards allow the Internal Auditing Director to determine whether management's oral or written response shows that action already taken by management is sufficient when weighed against the relative importance of the audit finding.

We indicated the status of our current follow-up efforts for each finding/observation within the last column of the attached report. When deemed necessary, due to the significance of a finding/observation, we verified management's corrective action taken by reviewing available documents or by performing additional follow-up testing. As indicated above, for those less significant findings/observations we may have deemed that the corrective action reported by management was sufficient and therefore did not warrant physical verification at this time. However, we will perform follow-up testing to verify implementation of corrective action taken for all findings/observations during our next regular audit of the program or activity in question.

**UNRESOLVED INTERNAL AUDIT FINDINGS/OBSERVATIONS, Status as of 9/20/01**

<b>Auditee</b>	<b>Audit # / Audit Activity</b>	<b>Period Reviewed</b>	<b>Report Issue Date</b>	<b>Description of Finding/Observation</b>	<b>Resolution or Status of Finding/Observation</b>	<b>F/U Status</b>
Disability Services (D/S), Client Benefits & Services Branch	#A-96024 Disability Benefit Application Process Audit	CY 1996	6/98	1. Standard Operating Procedures for the Disability Services Program have not been updated.	Concur & in progress. The D/S Division is working as part of a Client Benefits and Service Branch Procedures team. The team is charged with the responsibility to develop the format and criteria for the standardized business area procedures. Their oversight encompasses the development and deployment of written procedures to all CalSTRS staff. Due to the deployment and reconciliation of the START system, the Branch's efforts were delayed with respect to the fact that all business procedures would need to be re-written to include integration points with the START system. The initial completion date is expected to be June 30, 2002.	A, C
Disability Services (D/S), Client Benefits & Services Br.	#A-97026 Payments & Adjustments of Disability Benefits (aka Disability Benefits Audit)	1/96 to 9/97	8/98	1. The D/S section has not Developed or updated written policies and procedures to identify its current critical processes and related activities.	Concur & in progress. (Same as response above for audit #A-96024).	A, C

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**A** - Management concurred with finding/observation

**C** - Management indicated corrective action has been taken

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Service Retirements Div., Client Benefits & Services Branch	#A-99032 Inactive Member Accounts	7/94 to 3/99	3/00	3.The Service Retirements Div. does not have adequate internal controls to ensure that inactive refunds are made only to those members entitled to the refund.	Concur & in progress. Based on a survey of industry best practices of similar retirement systems, an issue memo will address approaches to obtaining independent third party verification of identity. Due to redirection of resources for the implementation of the new database and attrition of key staff associated with this project, the policy and procedure development and implementation will be delayed until March 2002.	A, C

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Support Accounting & Business Services, Administration Branch,	#A-95012 SAM 20000 Audit	FY 94/95 to 95/96	7/97	1. Properties with acquisition costs of \$5,000 or more are not capitalized in the accounting records.	Concur & corrected. Management developed a project plan to develop and implement procedures for capitalizing and depreciating assets in accordance with GASB 25.	A, C, R, N
				2. The Fiscal Services Div. inappropriately used the office revolving fund to pay for costs or expenses incurred while training school district payroll staff during the Employer Institute program.	Concur & corrected. Effective 7/1/97, all Employer Institute related expenditures will be budgeted/recorded in the Admin. Mgmt. Unit. A new expense code, 217.02, was established for such expenditures. A budget allotment of \$10,000 and a scheduled reimbursement of \$25,000 were established.	A, C, R, N
Survivor Benefits (S/B), Client Benefits and Services Branch	#A-95016 Detecting the Unreported Deaths of Benefit Recipients	7/95 to 10/98	7/99	1. S/B staff did not process the SCO's semi-annual death match reports for the period 10/95 to 4/97.	Concur & corrected. Management has updated operating procedures to provide staff with direction in evaluating, analyzing, and processing the reports. The related workload is being tracked and monitored within the monthly executive report.	A, C, R, N
				2. S/B did not establish formal timeframes for processing death match listings and did not enforce documentation deadlines, which	Concur & corrected. Management has established formal timeframes for working the reports, monitoring cases that exceed timeframes, and stopping benefit payments	A, C, R, N

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				<p>resulted in untimely resolution of certain death cases.</p> <p>3. For annuitants reported as "deceased in error" by another governmental agency, S/B staff did not always enforce procedures that require annuitants to submit verification of their identity and entitlement.</p>	<p>in a timely manner.</p> <p>Concur &amp; corrected. Management will closely monitor and evaluate cases in which payees claim hardship in complying with identity requirements. Overrides of verification requirements will be approved by the Disability and Survivor Benefits Div. Chief and reported monthly to the DCEO.</p>	<p>A, C, R, N</p>
Corp. Gov. & External Equities, Investments Branch	#A-96018 / 96020 Audit of External Managers' Evaluation Process	10/96 to 7/98	5/99	1. Management should develop written procedures for liquidating the portfolios of terminated external managers.	Disagree. The existence of the Pool Managers eliminates the need for liquidation procedures in the event of termination of other external managers.	D, N
Fixed Income, Investments Branch	#A-96019 / 96021 Review of Fixed Income Securities	7/96 to 10/11/96	2/97	<p>1. Some broker/dealers did not meet minimum requirements for broker/dealer selection set forth within CalSTRS' Investment Policy and some broker files did not contain sufficient documentation to verify that requirements were met.</p> <p>2. The trade ticket number and the</p>	<p>Concur &amp; corrected. A desk manual was created to ensure that the broker file documentation problems are eliminated.</p> <p>Concur &amp; corrected. Existing procedures</p>	<p>A, C, V, N</p> <p>A, C</p>

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				requester's name are not always entered on the Check-Out Log for SELL and BUY tickets.	were modified to ensure that the Check-Out Log is thoroughly completed with each transaction.	R, N
Investment Operations, Investments Branch	#A-96023 Cash Receipts & Cash Disbursements	6/97 to 8/97	4/98	1. Checks received by Inv. Ops. are not endorsed prior to being sent to the master custodian for credit to CalSTRS' account.	Concur & corrected. State Street Bank, the master custodian, prepared an endorsement stamp for Inv. Ops. staff to use restrictively for endorsing checks.	A, C, R, N
				2. Claim schedule file copies do not bear evidence of authorization or approval.	Concur & corrected. Claim schedule file copies are now initialed by the person approving the claim forwarded to the SCO.	A, C, R, N
				3. Requests to deny access to certain computer applications are not always executed timely.	Concur & corrected. The Inv. Br. began using a new Computer Access Clearance form in 4/98 and implemented procedures for tracking staff's computer access.	A, C, R, N
Disability Services (D/S), Client Benefits & Services Branch	#A-96024 Disability Benefit Application Process Audit	CY 1996	6/98	2. Sufficient documentation is not being obtained to verify the financial dependency of a member's child at the time of application. Auditor recommended that current law be reviewed for proper compliance and that necessary procedures be implemented.	Disagree. Staff use the child's age and the member's certified signature on the application to verify financial dependency. However, management does recognize that there are situations for which further documentation is needed.	D, N

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				3. CalSTRS uses the postmark date, rather than the CalSTRS receipt date to record the date application is received.	Concur & corrected. A policy to use only the application "receipt date" has been instituted.	A, C, R, N
Admin. Serv. Div., Admin. Br., & Accounting Div., Information & Financial Systems Br.	#A-96025 Financial & Management Reporting Process	7/96 to 1/97	1/13/98	1. Claim Schedules prepared in Support Acctng. did not reflect the signature of the person authorized to provide approval.	Concur & corrected. Staff have been separating the file copy of the claim schedules (C/S) prior to obtaining a signed approval of the claim. Consequently, there was no evidence of approval on the C/S file copies housed in Support Acctng. Staff have been instructed to sign the complete claim schedule upon their review/approval prior to separating the C/S copies.	A, C, R, N
Disability Services (D/S), Client Benefits & Services Br.	#A-97026 Payments & Adjustments of Disability Benefits (aka Disability Benefits Audit)	1/96 to 9/97	8/98	2. When adjusting some members' final compensation benefits, staff must override existing information in order to calculate the adjusted compensation amount. Over-ridden data will not be picked up by the system once START is implemented.	Concur & corrected. According to the START system experts, over-ridden data will continue to exist in the START environment. Similar to IDMS, there will continue to be occasions when staff will need to override the calculator. For example, overrides are needed for calculations of part-time and/or non-consecutive years and for Option 8 benefit calculations.	A, C, R, N
				3. Staff did not always date	Concur & corrected. All calculation	A, C

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				and initial the calculation forms used to document their manual calculation of members' final compensation amounts.	technicians are currently signing and dating the manual calculation forms. Staff is working to deploy all D/S forms on the Intranet. The version control functionality of the software allows for author, version, and date control for each document. This will provide an unalterable historical audit trail for the forms.	R, N
Alternative Investments, Investments Branch	#A-97027 Alternative Investments	CY 1997	12/98	<ol style="list-style-type: none"> <li>1. The Alternative Investments Policy was not revised to reflect the current environment of the Alt. Inv. unit and did not provide guidelines for the portfolio structure.</li> <li>2. The partnership legal file is not always consulted to determine the actual fund size of the investment prior to preparing the Alternative Investment Status Report.</li> </ol>	<p>Concur &amp; corrected. The Alternative Investments Policy &amp; Procedures Manual was revised and approved by the Inv. Comm. at the 6/3/98 meeting.</p> <p>Concur &amp; corrected. All partnership agreements have been reviewed to validate the fund size. Written documentation was obtained to support general partner's commitments. Staff are reviewing each fund to obtain a final closing set of documents. The monthly status report, effective 5/98, identifies commitments in international funds and footnotes currency conversion information.</p>	<p>A, C, V, N</p> <p>A, C, V, N</p>

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				3. Some funds' management fees are inappropriately being capitalized and are not being recognized as an expense.	Concur & corrected. Staff have identified all inappropriately capitalized fees, have adjusted the commitment amount for each partnership, and have obtained Inv. Comm. approval of the increased commitments.	A, C, V, N
				4. Staff are processing capital call requests and wiring funds to partnerships prior to verifying the authenticity of the request. Funds are released based on facsimiles and photocopies of capital call notices. Notices are not always signed by authorized personnel. Also, verbal confirmations, from the general partner, are not always obtained and/or documented on the request.	Concur & corrected. New partnership agreements include the name and specimen signature of authorized personnel. Staff have been instructed to obtain verbal confirmation of all capital call requests and document the confirmation, prior to wiring funds.	A, C, R, N
				5. There are several weaknesses within the internal control system over CalSTRS' Alt. Inv. Function.		
				(a)The Alt. Inv. unit does not	(a) Concur & corrected. The Internal Equity	A, C

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				have adequate separation of duties over its stock process, including stock monitoring, sales, and distribution activities.	unit, within the Inv. Br., now manages the sale of stock and performs a secondary level of review for all sale recommendations. The stock distribution and accounting process is performed within the Alt. Inv. Unit and activities are reported to Int. Eq.	R, N
				(b)The Inv. Br. does not maintain an independent record of (Alt. Inv. portfolio) stock held by the master custodian or by brokers.	(b) Disagree. Int. Eq. staff currently monitor custodial records of stock (held by custodian) and reconcile differences with the custodian. All stock is now transferred to the custodian with none being held by the broker.	D, N
				(c)The gain or loss from stock sales is not included within the Alt. Inv. Monthly Report to the Inv. Comm.	(c) Concur & corrected. The stock assets have been transferred to the TC95 and TC96 portfolios. The performance was presented in the <i>Post Distribution Stock Portfolio Performance</i> report submitted to the Investment Committee during its Closed Session meeting on March 7, 2001. Management has concurred that its Consultant is reporting the gain or loss from stock sales in its report to the Investment Committee each month.	A, C, V, N

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Fixed Income, Investments Branch	#A-98029 Securities Lending Program	CY 1998	2/00	<p><b>Note:</b> <i>Observations identified within the audit report were grouped into the following four categories:</i></p> <p><b>1. Monitoring:</b> Staff could improve monitoring activities and provide more oversight of S/L agents' compliance with contract and program policy requirements. Specifically, staff should more closely monitor:</p>	Management assigned additional staff to the program starting the 4 <sup>th</sup> quarter of FY 99/00 to review agents' compliance contracts and policies. Staff have completed the fourth and final Securities Lending Agent's contract and are in the process of standardizing the reporting and updating the procedures documentation	A, C, V, N
				(a) Agents' daily collateral margin maintenance,	(a). Concur & corrected. Agents' daily collateral value reports are being closely tracked and monitored.	A, C, R, N
				(b) Agents' submission of financial reports, and	(b). Concur & corrected. A checklist is now being utilized to monitor the agent's submission of financial reports.	A, C, R, N
				(c) Evidence regarding agents' reevaluations of borrowers' creditworthiness.	(c) Concur & corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating the procedures documentation.	A, C, R, N

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				<p>(d) Staff should more thoroughly monitor agents' S/L program result reports and</p> <p>(e) document their review and use of external reports provided by the S/L consultant.</p> <p>2. <b>Reporting:</b> (a) S/L program results were not always reported accurately within monthly reports to the CIO &amp; Inv. Comm. due to the variety of reporting formats used by each of the S/L agents.</p> <p>(b) Also, the format used to report monthly results to the Inv. Comm. is inconsistent in that monthly program earnings are excluded.</p> <p>3. <b>Procedures:</b> Staff should develop new or enhance existing</p>	<p>(d) Agents have been directed to perform monthly reconciliations with the custodian and to submit audit reports covering their internal controls.</p> <p>(e). Concur &amp; corrected. The consultant's reports are being more fully monitored and documented for follow-up.</p> <p>(a) Concur &amp; corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating the procedures documentation. Previous reporting errors have been resolved and corrected.</p> <p>(b) Disagree. The format used by the CIO to report monthly program results to the Inv. Comm. was one requested by the Inv. Comm. itself.</p>	<p>A, C, R, N</p> <p>A, C, R, N</p> <p>A, C, R, N</p> <p>D, N</p>

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				<p>procedures/guidelines for some key processes. This includes:</p> <p>(a) Enhancing guidelines for (internal) management of cash collateral portfolios,</p>	<p>(a) Concur &amp; corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating both the Procedures and Desk Manual to reflect any changes.</p>	A, C, R, N
				<p>(b) Developing custodial instructions for holding back a portion of all loanable assets, and</p>	<p>(b) Concur &amp; corrected. Staff will consider developing more formal procedures if/when additional agents are added.</p>	A, C, R, N
				<p>(c) Maintaining existing procedures regarding the recall and voting of loaned securities.</p>	<p>(c) Concur &amp; corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating both the Procedures and Desk Manual to reflect any changes. The updated S/L or Corporate Governance manuals will address recall and voting of loaned securities.</p>	A, C, R, N
				<p>4. <b>Agent Contracts:</b></p> <p>(a) S/L agents' contract language is not standardized with regard to earnings</p>	<p>(a) Concur &amp; corrected. Staff have completed the fourth and final contract and are in the process of standardizing</p>	A, C, R, N

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				requirements and reporting format requirements.	the reporting and updating both the Procedures and Desk Manual to reflect any changes	
				(b) Indemnification clauses could be strengthened.	(b) Concur & corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating the procedures documentation. Staff will continue to seek all opportunities to mitigate risks associated with S/L.	A, C, R, N
				(c) Agents could be provided with more specific guidelines regarding their mark-to-market activities,	(c) Concur & corrected. Agents are using a new process for transmitting daily collateral level data.	A, C, V, N
				(d) Borrower selection criteria, and	(d) Concur & corrected. Staff have completed the fourth and final contract and are in the process of standardizing the reporting and updating the procedures documentation.	A, C, R, N
				(e) Management of cash collateral investments.	(e) Disagree. Staff closely monitor agents' investment activities but management is reluctant to dictate specific investment guidelines to agents since it could hinder	D, N

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<b>Auditee</b>	<b>Audit # / Audit Activity</b>	<b>Period Reviewed</b>	<b>Report Issue Date</b>	<b>Description of Finding/Observation</b>	<b>Resolution or Status of Finding/Observation</b>	<b>F/U Status</b>
					agents' abilities to implement their (own) investment strategies.	
Service Retirements Div., Client Benefits & Services Br.	#A-99032 Inactive Member Accounts	7/94 to 3/99	3/00	1. CalSTRS has not made a good faith effort to periodically locate its inactive members and inform them concerning their pension benefits as required by California Education Code, Section 22309(b).	Concur & corrected. The Service Retirements (SR) Division is using various Internet websites as a tool to locate inactive members approaching 70 ½ years of age. An additional service was utilized during the annual mailing of information to inactive members. The “Forwarding Order Requested” (FOR) service was utilized for the first time and resulted in a significant reduction in returned mail when the inactive members were contacted regarding their pension benefits. The statistics regarding the results of the communication will be available in 60 days.	A, C, R, N
				2. One staff member who had access to inactive member account data was assigned incompatible computer functions within CalSTRS' information system.	Concur & corrected. The staff member's access to various computer functions has been realigned.	A,C, R, N

**LEGEND for F/U Status:**

**A** - Management concurred with finding/observation

**C** - Management indicated corrective action has been taken

**D** - Management disagreed with finding/observation and has assumed the risk of not correcting the reported condition due to cost benefit and other considerations

**V** - Office of Audits verified corrective action

**R** - Internal Audit Director deemed that management's corrective action is sufficient and does not require verification at this time

**N** - No further follow-up required at this time

Underline – Finding/Observation was resolved since last Budgets and Audits Committee Meeting held on April 5, 2001.